Ontario Studies in Tax Reform 5

Technical Study on Integration

Staff Paper

Department of Treasury and Economics
Taxation and Fiscal Policy Branch

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ONTARIO

Taxation and Fiscal Policy Branch
Ontario Department of Treasury and Economics

ONTARIO PROPOSALS FOR TAX REFORM IN CANADA

I	Hon. Charles MacNaughton	Ontario Proposals for Tax Reform in Canada
II	Hon. Charles MacNaughton	Tax Reform and Small Business
III	Hon. W. Darcy McKeough	Taxation of Corporations and Shareholders

ONTARIO STUDIES IN TAX REFORM (Staff Papers)

1. Analysis of the Federal Tax Reform Proposals
2. Effects of Ontario's Personal Income Tax Proposals
3. Technical Study on Tax Reform and Small Business
4. Tax Reform and Revenue Growth to 1980
5. Technical Study on Integration

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Frost Building, Queen's Park,
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PREFACE

In June 1970, the Ontario Government published the *Ontario Proposals for Tax Reform in Canada.* This was followed by a more fully developed set of proposals for the taxation of small business, contained in the paper, *Tax Reform and Small Business,* published in December, 1970. The general proposals of the Ontario Government for the taxation of corporations and their shareholders have now been expanded in the paper, *Taxation of Corporations and Shareholders,* issued by the Hon. W. Darcy McKeough, Treasurer of Ontario and Minister of Economics, in April, 1971. This supporting study analyses in some detail the administration and accounting which would be necessary under a general system of half integration of the corporate and shareholder tax. It displays the complexity and deadweight of the proposed system and the resultant difficulty in making such a system work in practice.

This staff study was undertaken in the Taxation and Fiscal Policy Branch, Ontario Department of Treasury and Economics, as part of the continuing series of Ontario Studies in Tax Reform. In preparing this study we drew on the expertise and knowledge of outside advisers and consultants, including tax lawyers and accountants. We wish to acknowledge their major contribution.

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Deputy Treasurer and
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April, 1971

TABLE OF CONTENTS

LIST OF TABLES

TECHNICAL STUDY ON INTEGRATION

Introduction

1 In its white paper on tax reform the federal government proposed the integration of corporate and shareholder taxation through a system of gross-up and credit.[1] The 20 per cent dividend tax credit would be abolished and would be replaced by a system of taxation which would provide full integration for closely-held corporations and half integration for widely-held corporations. Under such a system corporate tax paid would be treated as a pre-payment of the shareholder's tax. In the case of full integration, all of the corporate tax paid would be so treated, whereas in the case of partial or half integration only 50 per cent of the corporate tax would be so treated. The Commons Committee gave qualified approval to a general system of half integration with a limited form of full integration for Canadian-controlled closely-held companies.[2]

2 This technical study describes the general scheme of integration and reviews the need for corporations to identify and record amounts of creditable tax for purposes of advising shareholders. Procedures to identify creditable federal tax, creditable provincial tax and creditable foreign tax at the corporate level are set down, together with a discussion of the use of this information by the individual or corporate shareholder. Much of the discussion will relate to the administration and accounting under a general system of half integration. Appendix A to the study illustrates the accounting for integration by a hypothetical Canadian company and describes a possible form of corporate reorganization to obtain the maximum benefit for the various types of shareholders. While the federal white paper proposed a system of full integration by way of partnership option for Canadian closely-held companies, this subject is not dealt with in this study.

3 The comments as to methods and procedures to be employed have been based as far as possible on the original federal white paper on tax reform and on the technical paper on this subject issued by the Department of Finance on March 19, 1970.[3] Even with the benefit of these documents, all the necessary information to analyze fully the integration proposal is not available. Consequently, it has been necessary to make a number of assumptions concerning procedures to be employed.

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[1] Hon. E.J. Benson, *Proposals for Tax Reform* (Ottawa: Queen's Printer,1969), hereinafter referred to as the federal white paper.

[2] *18th Report of the Standing Committee on Trade, Finance and Economic Affairs Respecting the White Paper on Tax Reform* (Ottawa: Queen's Printer, 1970), hereinafter referred to as the *Commons Report*.

[3] Department of Finance, "Giving Shareholders Credit for Corporate Taxes", mimeo, Ottawa, March 19, 1970.

The General Scheme

4 Under the integration system, a shareholder, on receipt of a (cash or stock) dividend, would include in his income the actual dividend received plus the amount of corporate tax considered to have been paid on his behalf. He would compute his personal tax on the grossed-up amount and would claim credit against his resulting tax liability for the corporate tax paid. This procedure may be illustrated as follows:

	Shareholder's Marginal Rate of Personal Income Tax		
	0%	30%	60%
Full Integration			
Stock or cash dividend received	$100	$100	$100
Add corporation tax considered to have been paid on behalf of the shareholder	100	100	100
Gross income	$200	$200	$200
Gross tax	$ 0	$ 60	$120
Less credit for corporation tax	100	100	100
Tax owing (refund)	($100)	($ 40)	$ 20
Shareholder's net retention	$200	$140	$ 80
Half Integration			
Stock or cash dividend received	$100	$100	$100
Add corporation tax considered to have been paid on behalf of the shareholder	50	50	50
Gross income	$150	$150	$150
Gross tax	$ 0	$ 45	$ 90
Less credit for corporation tax	50	50	50
Tax owing (refund)	($ 50)	($ 5)	$ 40
Shareholder's net retention	$150	$105	$ 60

Creditable Corporate Tax

5 The amount of corporate income tax considered to have been paid on behalf of the shareholders would be determined by reference to actual payments of tax by the corporation. The portion of the corporate tax which was creditable to shareholders, i.e. 100 per cent or 50 per cent, would flow with dividend payments dollar-for-dollar, or dollar-for-two-dollars, until the total pool or fund of creditable tax was exhausted. If dividends were paid at a time when the corporation had little or no creditable tax, the shareholders

would receive dividends carrying less than the maximum creditable tax. Only the amount considered to flow to them would be reflected in the gross-up and credit calculation. This is illustrated as follows under a system of half integration for an individual shareholder having a 30 per cent marginal rate of tax.

	Corporate Tax Paid		
	$ 0	$ 50.00	$100
Stock or cash dividend received	$100	$100.00	$100
Add corporation tax considered to have been paid on behalf of the shareholder	0	25.00	50
Gross income	$100	$125.00	$150
Gross tax	$ 30	$ 37.50	$ 45
Less credit for corporation tax	0	25.00	50
Tax owing (refund)	$ 30	$ 12.50	($ 5)
Shareholder's net retention	$ 70	$ 87.50	$105

6 It would thus be necessary that shareholders be advised of the amount of creditable tax flowing with a dividend in order that they could properly compute their income and tax. Presumably this reporting would be done by the paying corporation through the use of an expanded form of information slip such as is now provided to report annual payments of dividends. Since it is expected that creditable tax will flow through a series of corporations and presumably through most trusts, it is expected that such reporting would be made with each dividend payment to each shareholder. Since current knowledge of creditable tax would also be necessary for shareholders and potential investors, details would need to be provided in information circulars, prospectuses and balance sheets. Annual reporting of creditable tax accounts would be made to the taxation authorities at the time of filing the corporation income tax return.

Corporate Creditable Tax Accounts

7 Under the integration proposal, corporations would find it necessary to keep track of taxes actually paid in order to provide shareholders with the required information. Depending on the degree of integration permitted all or part of their Canadian taxes paid would be treated as creditable. With full integration, a company paying $50,000 tax on taxable income of $100,000 would add the $50,000 to the pool of creditable Canadian tax. In the case of half integration only $25,000 would be treated as creditable, and the remaining $25,000 would be regarded as non-creditable. The pool of creditable tax would be reduced by amounts flowing to shareholders on the payment of dividends. So long as sufficient creditable tax remained in the pool, dividends paid would be accompanied by the maximum amount of creditable tax. As described previously, a Canadian shareholder would

include in income the "grossed-up" dividend (i.e. the amount of the dividend plus the creditable tax associated with it) and would treat the creditable tax as a payment on account of his tax.

8 The federal government in its white paper expressed concern that the integration proposal could give rise to abuses unless a staledating provision or time limit was placed on the use of creditable tax. Accumulations of creditable tax over a number of years, coupled with trading in rights to creditable tax, could set the stage for a considerable drain on government revenues. It was proposed therefore, that the corporate tax would only be integrated with the shareholder tax if it were passed on to the shareholder, along with cash or stock dividends paid, within 2½ years from the end of the taxation year to which the corporate tax applied. Because of a number of difficulties which such a time limit requirement would cause for corporations working under debt-covenant restrictions, for corporations who would be continually faced with a requirement to declare stock dividends, and for shareholders who would be required to make net cash payments on such stock dividends, the Commons Committee recommended that the staledating rule be dropped. If the federal government's concerns are still valid, it would be necessary that corporations maintain their records of creditable tax on a year-by-year basis. No indication has as yet been given which would suggest that the staledating rule will be dropped.

9 The accounting which would be involved in dealing with creditable tax under a system of half integration is shown in summary form in the following table.

Table 1

Accounting for Creditable Tax

	Corporate Earnings				Tax Payable			Creditable Tax Accounts	
	Earnings	Tax Provision	Dividends	Balance	Provision	Payments	Balance	Non-Creditable Tax	Creditable Tax Year 1
Year 1									
Earnings	$100,000			$100,000					
Tax on taxable income		$50,000		50,000	$50,000		$50,000		
Tax instalments paid						$40,000	10,000	$20,000	$20,000 (1)
Dividends paid			$20,000	30,000					(10,000) (2)
Year 2									
Balance of Year 1 tax						10,000	0	5,000	5,000 (1)

NOTES:
(1) 50% of tax instalments
(2) 50% of dividends paid

Creditable Federal Tax and Creditable Provincial Tax

10 The federal white paper proposed changes in the level and composition of the personal income tax. Among those items to be eliminated was the present abatement in respect of provincial personal income tax. A new federal rate schedule was proposed and it was suggested that the provinces could maintain approximately their present revenue yield by continuing to impose their present rates of personal income tax.

11 Under the present system the federal basic tax is abated by 28 per cent (50 per cent in Quebec) in respect of provincial taxes to arrive at a net federal basic tax. To this are added various federal tax adjustments which aggregate an amount equal to approximately 28 per cent[4] of the basic tax. For those provinces now levying a personal income tax equal to 28 per cent of the federal basic tax (Nova Scotia, Ontario and British Columbia) the provincial share of the total is thus approximately 22 per cent (i.e. 28/128). Should those provinces continue to levy a tax of 28 per cent of the federal tax they would continue to obtain approximately 22 per cent of the total personal income tax levied in the province. All provinces would of course continue to be free to levy a higher rate of personal income tax.

12 The federal corporate income tax would continue to be abated by 10 per cent for provincial corporate income tax resulting in a net 40 per cent federal tax. To this would be added provincial corporate income taxes which at the moment range from 10 to 13 per cent.

13 It was proposed that for purposes of integration provincial tax rates in excess of the federal abatement would be ignored. Thus a 40 per cent federal rate plus an assumed 10 per cent provincial rate would be used for gross-up and credit purposes. The alternative of employing actual provincial corporate rates was rejected as creating enormous complexities in corporate reporting and shareholder gross-up and credit calculations.

14 Under the federal government's proposals, the amount of creditable corporate tax would thus be in a ratio of 40:10 or 80 per cent federal and 20 per cent provincial tax. The shareholder would gross-up his dividends utilizing the 50 per cent national rate of creditable corporate tax and would take credit against his personal tax payable in the ratio of 80 per cent federal and 20 per cent provincial. This may be illustrated as follows:

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[4] The principal adjustments are: the Old Age Security Tax (4 per cent), the Social Development Tax (2 per cent), and the temporary 3 per cent surtax.

Advice Slip from Corporation to Shareholder		
Actual dividend paid		$100
Creditable tax		
federal	$40	
provincial	10	50
Income to be reported		$150

Tax Calculation by Shareholder		
Gross income		$150
Tax payable – federal (assuming 30% marginal rate)		
Tax	$45	
Less credit for corporate tax	40	
Net federal tax		$ 5.00
Tax payable – provincial		
Tax at 28% of $45	$12.60	
Less credit for corporate tax	10.00	
Net provincial tax		2.60
Total tax		$ 7.60

Corporate Tax Payments to Provinces having Collection Agreements

15 Corporations making provincial tax payments only to provinces which have entered into collection agreements with the federal government should be able to maintain one creditable tax account for both federal and provincial tax. Since under the present form of collection agreements the tax base must be identical, it should be possible for such corporations to treat any creditable tax payments as being 80 per cent federal tax and 20 per cent provincial tax.

16 Under the present collection agreements, the provinces receive their share of the corporate tax revenues by reference to taxes assessed rather than to taxes actually collected. Thus, the province escapes from bad debt losses and may, in fact, receive more tax than is ultimately collected from the corporation. (On the other hand, the federal government retains all interest, penalties and fines collected.) Only taxes actually paid will give rise to creditable tax and only if paid within 2½ years of the year to which they apply. Therefore, in situations where the ultimate corporate tax paid is less than that assessed, the use of the 80:20 formula could result in the federal government giving credit for a tax which it has not received but which has been remitted to a province.

17 It should not be necessary for the corporation to identify on the information slips the province to which their corporate tax was paid since it is intended that the provinces give a credit against the personal income tax of their taxpayers for provincial corporate tax paid to any province. Similarly a corporation carrying on business in a number of collection-agreement provinces would not find it necessary to segregate for reporting purposes the tax paid to each of the provinces and to the federal government. The total amount of creditable tax can be allocated in the 80:20 ratio with the federal government giving credit against its personal income tax for the creditable federal tax and the province of residence of the shareholder giving credit for the creditable provincial tax.

Corporate Tax Payments to Provinces not having Collection Agreements

18 At the moment both Ontario and Quebec collect their own corporate income tax. Their tax bases are substantially identical to that of the federal government. However their corporate tax instalment requirements are quite different. The federal tax is currently payable in twelve monthly instalments due at the end of each month throughout the course of the taxation year. Ontario's corporate tax instalments are payable in six bi-monthly payments commencing with the fifteenth day of the third month of the taxation year. Quebec corporate income tax, on the other hand, is payable in four instalments on the fifteenth day of the third, sixth, ninth and twelfth months of the taxation year. It is thus possible that a company paying corporate tax to Ontario or Quebec or to both could have creditable federal tax but no creditable provincial tax (or less than the typical 80:20 proportion) on hand at the time of the payment of a dividend. This is illustrated in the table below for a corporation whose tax is as follows:

	Total Tax	Creditable Amount
Federal	$24,000	$12,000
Ontario	3,000	1,500
Quebec	3,000	1,500
	$30,000	$15,000

Table 2

Creditable Tax for a Company Paying Tax in Ontario and Quebec

Month in Taxation Year	Payment of Tax	Creditable Federal Tax	Creditable Provincial Tax	Cumulative Creditable Provincial Tax	Amount of Creditable Provincial Tax Necessary to Maintain 80:20 Ratio
1	$ 2,000	$ 1,000			$ 250
2	2,000	1,000			500
3	3,250(1)	1,000	$ 625	$ 625	750
4	2,000	1,000		625	1,000
5	2,500	1,000	250	875	1,250
6	2,750	1,000	375	1,250	1,500
7	2,500	1,000	250	1,500	1,750
8	2,000	1,000		1,500	2,000
9	3,250	1,000	625	2,125	2,250
10	2,000	1,000		2,125	2,500
11	2,500	1,000	250	2,375	2,750
12	2,750	1,000	375	2,750	3,000
13	500		250	3,000	3,000
15	Balance of federal tax for year				
18	Balance of Ontario and Quebec tax for year				
	$30,000	$12,000	$3,000		

(1) 1/12 x $24,000, 1/6 x $3,000, 1/4 x $3,000

19 Even if the provincial and federal instalment requirements were identical, experience would suggest that some corporations will not pay their taxes by the due date and would not necessarily make their federal and provincial payments on the same day.

20 Should a corporation be liable for corporate tax payments to a province having a collection agreement and as well as to either or both of Ontario and Quebec, it would be necessary to segregate the portion of the provincial tax included in the monthly payment to the federal government in order to identify the federal and provincial portions of the payments and the creditable tax content. In such cases it would not be possible to use the 80:20 allocation formula.

Non-creditable Provincial Tax Payments

21 The previous examples have been drawn on the basis that a 10 per cent provincial corporate tax would be fully (or half) creditable. As noted previously, the actual provincial corporate tax rates would not be used because of the complexity which would result.

Accordingly, income tax paid to some provinces would be fully creditable (or half creditable) whereas tax paid to other provinces would not be fully creditable. Under a system of half integration, the provincial income tax would be treated as follows:

	Creditable Tax	Non-creditable Tax
10% rate – British Columbia New Brunswick, Nova Scotia and Prince Edward Island	5%	5%
11% rate – Alberta and Saskatchewan	5%	6%
12% rate – Ontario and Quebec	5%	7%
13% rate – Manitoba and Newfoundland	5%	8%

22 The previously discussed federal-provincial allocation of creditable tax on an 80:20 basis for collection-agreement provinces would continue to work but it would be necessary to first identify and exclude the additional non-creditable portion of the total payment before applying the 80:20 formula.

23 An instalment of tax paid by a corporation earning all of its income in Alberta or Saskatchewan would be allocated as follows under a half integration system:

Instalment	$1,000
Non-creditable portion 26/51 x $1,000	510
Creditable portion	$ 490
Creditable federal tax 80% of $490	$ 392
Creditable provincial tax 20% of $490	98
	$ 490

24 Alternatively the calculation could be made by reference to the total instalment in the following way:

Creditable federal tax 20/51 x $1,000	$392
Creditable provincial tax 5/51 x $1,000	98
	$490

25 An instalment of tax by a corporation earning all of its income in Manitoba or Newfoundland would be allocated as follows:

Instalment	$1,000
Non-creditable (28/53)	528
Creditable federal tax (20/53)	378
Creditable provincial tax (5/53)	94
	$1,000

26 If the income of the corporation were allocable 60 per cent to Manitoba and 40 per cent to Saskatchewan the calculation would be as follows:

Instalment	$1,000
Non creditable (27.2/52.2) (1)	521
Creditable federal tax (20/52.2)	383
Creditable provincial tax (5/52.2)	96
	$1,000

(1)	60% x 53% =	31.8%
	40% x 51% =	20.4%
		52.2%

27 Corporations making instalments directly to Ontario and Quebec would need to exclude the capital tax elements of their payment in determining the amount of creditable tax. Since both provinces levy a 12 per cent corporate rate the income tax portion of the instalment could then be treated as being 5 per cent creditable and 7 per cent non-creditable. A corporation earning all of its income in Ontario and/or Quebec could consider its federal tax instalment as fully or half creditable depending on the degree of integration.

28 A corporation earning part of its income in Ontario or Quebec and part in another province would follow this same procedure in determining the portion of its Ontario or Quebec instalment which was creditable (i.e. 5/12ths of the income tax element of the payment). However, in determining the creditable portion of the payment to the federal tax authorities, it would be necessary to vary the calculation from that previously described. For example, a corporation earning 60 per cent of its income in Ontario and 40 per cent in Manitoba would compute the creditable portion of the federal – Manitoba instalment as follows:

Instalment	$1,000
Non-creditable (23.2/45.2) (1)	513
Creditable federal tax (20/45.2)	443
Creditable provincial tax (2/45.2) (2)	44
	$1,000

(1)	federal	40.0%
	Manitoba 40% x 13% =	5.2%
		45.2%

(2) 40% x 5% = 2%

Non-deductible Expenditures

29 It was proposed in the federal white paper that taxes paid by a corporation as a result of the disallowance of particular expenditures e.g. entertainment and convention expenses, would not be creditable to the shareholders. It would thus be necessary to identify such tax in order to exclude it from both the creditable federal tax and creditable provincial tax. It is not known whether this non-creditable tax arising from non-deductible expenditures will be considered part of the first instalments, part of the last or final instalments or pro-rated over all payments made.

30 While the tax bases of Ontario and Quebec are substantially the same as the federal, they are not identical. For example, Ontario does not allow a deduction for management fees paid to non-residents which require a withholding of tax under Section 106 (1) (a) of the Income Tax Act, whereas such payments would generally be deductible in determining federal income tax. Even where the bases are identical, differences in the determination of taxable income do arise and federal and provincial assessors will on occasion disagree as to the appropriate tax treatment of a particular item of income or expense.

31 Where provincial tax is paid as a result of a disallowed expenditure, it would seem that the provincial tax should be treated as non-creditable at least insofar as shareholders resident in that province are concerned. Shareholders resident in a province which would consider the expenditure to be deductible might argue that they should receive credit for such provincial tax in their province of residence. Any differences of this sort can be expected to create reporting problems for a corporation which might be carrying on business in two provinces, one allowing the deduction and the other not.

Overpayments and Refunds

32 As noted above, tax generally would become creditable at such time as it was paid and to the extent available would flow to shareholders with the payment of dividends. If a refund of tax were claimed as a result of overpayments of tax in the year, the carry-back of a subsequent year's loss or a reduction in tax liability arising on reassessment, the non-creditable portion of the over-paid tax would be recoverable. However, creditable tax would only be recoverable to the extent it had not been carried to shareholders with dividends. If this resulted in the inability to obtain a full recovery of tax, the remaining amount could be offset against future payments. The accounting for this is illustrated in Table 3.

Table 3

Accounting for Creditable Tax: Overpayments and Refunds

	Corporate Earnings	Taxes Payable	Refundable Creditable Tax	Non-Creditable Tax	Creditable Federal Tax	Creditable Provincial Tax
Year 1						
Earnings	$20,000					
Tax on income	(10,400)	$10,400		$5,400	$4,000	$1,000
Tax payments		(10,400)			(2,000)	(500)
Dividends	(5,000)					
	$ 4,600	$ 0		$5,400	$2,000	$ 500
Year 2						
Loss	(16,000)					
Tax recovery on carry back of loss	8,300	(8,300) (1)		4,300	2,000 (2)	500 (2)
Refund		6,800				
Refundable		1,500	$1,500 (3)			
	$ (3,100)	$ 0	$1,500	$1,100	$ 0	$ 0
Year 3						
Earnings	5,000					
Tax on income	(2,600)	2,600				
Tax payments		(1,300)		1,300		
Tax liability offset by refundable creditable tax		(1,300)	(1,300)			
	$ (700)	$ 0	$ 200	$2,400	$ 0	$ 0

NOTES: (1) Year 1 earnings $20,000
Less Year 2 loss 16,000
$ 4,000

		Non-Creditable Tax	Creditable Federal Tax	Creditable Provincial Tax
Tax	$ 2,100	$1,100	$ 800	$ 200
Tax previously paid	10,400	5,400	4,000	1,000
Potential recovery	$ 8,300	$4,300	$3,200	$ 800

(2) Limited to amount of creditable tax on hand.

(3) Refundable out of future years' creditable tax.

Assessments and Appeals

33 The general proposal was that corporate tax would become creditable when paid and would cease to be creditable 2½ years after the end of the taxation year to which it applied. (Tax not paid until after the 2½ year period would thus never become creditable.) Since it is common for assessments and reassessments to be issued beyond this thirty month period, special rules were proposed under which tax demanded by an assessment or reassessment would remain creditable for eighteen months from the end of the taxation year in which the assessment was issued. Where an objection and/or appeal were filed in respect to an assessment the tax demanded would be frozen until such time as the matter was settled at which time it would become refundable or creditable (or partly each). Specific procedures would need to be prescribed to deal with situations where tax is not paid on the due date but security for payment is lodged with the taxation authorities pending the outcome of an appeal. Thus the recording of creditable tax payments would become somewhat more complex where assessments or appeals were involved. The accounting is illustrated in Table 4. In order to simplify the illustration federal and provincial creditable taxes have been aggregated, although in practice they would have to be accounted for separately.

Table 4

Accounting for Creditable Tax: Assessments and Appeals

	Dividends Paid	Amount of Tax Paid	Non-Creditable Tax	Creditable Tax Paid re Year 1	Creditable Tax Paid re Year 2	Creditable Tax Paid re Year 3	Creditable Tax Assessed Year 3 re Year 1	Creditable Tax Assessed Year 3 re Year 2 Suspense	Creditable Tax Paid re Year 4	Creditable Tax Assessed Year 3 re Year 2 Objection Dropped
Year 1										
Tax instalments		$52,000	$27,000	$25,000						
Dividend	$30,000			(15,000)						
Year 2										
Balance of Year 1 tax		6,000	3,100	2,900						
Tax instalments		60,000	31,200		$28,800					
Dividend	30,000			(12,900)	(2,100)					
Year 3										
Balance of Year 2 tax		5,000	2,600		2,400					
Tax instalments		65,000	33,700			$31,300				
Dividend	30,000				(15,000)					
Tax assessment re Year 1		5,000	4,000(1)				$1,000			
Tax assessment re Year 2 – objection filed		9,000	5,000(1)					$4,000		
Year 4										
Balance of Year 3 tax		5,000	2,600			2,400				
Tax instalments		65,000	33,700						$31,300	
Year 2 objection dropped								(4,000)		$4,000
Dividend	30,000				(14,100)	(900)				
Tax creditable until						Year 3 plus 30 months	Year 3 plus 18 months		Year 4 plus 30 months	Year 4 plus 18 months

NOTE: (1) Including tax paid on certain disallowed expenses where tax is to be non-creditable.

34 A number of questions can be raised concerning the accounting for creditable tax where overpayments and assessments are encountered. For example:

a. Tax becomes creditable when paid. In the case of an assessment, tax must be paid within thirty days even if an objection is to be filed. A notice of objection may be filed up to ninety days from the date of assessment. A dividend carries out any creditable tax on hand (up to the maximum of 50 per cent or 100 per cent of the dividend) at the time it is paid. What happens if an assessment is received, the resulting tax is paid on the thirtieth day, a regularly quarterly dividend is paid on the fortieth day and an objection is filed on the ninetieth day? If the dividend has carried out the creditable tax, is the objection invalid? Presumably the objection should be valid and if successful should result in a recovery of the non-creditable tax with a potential offset against a future liability for creditable tax. If the objection should not be successful and the assessment should stand, the tax will have been properly paid. The tax will have become creditable somewhat earlier than would have been the case if the objection had been filed prior to the payment of the dividend (since it would have been held in suspense until such time as the objection had been resolved).

b. The payment of instalments in Year 1 for that year gives rise to creditable tax and the staledating period starts from the end of Year 1. If a return showing an overpayment is filed, the amount of tax claimed to be refundable ceases to be creditable. Presumably, if the taxpayer directs that the overpayment be applied to the current year's tax (i.e. Year 2), the creditable tax would be moved from Year 1 creditable tax to Year 2 creditable tax. If an assessment were issued in Year 2 increasing the tax of Year 1, the taxpayer might direct that the overpayment of tax from Year 1 be applied against that assessment. Presumably, that creditable tax now moves from Year 2 creditable tax with a thirty month staledating provision to Year 2 creditable tax with an eighteen month staledating provision, being tax demanded in Year 2 by an assessment. Or does it return to Year 1 creditable tax with a thirty month staledating provision as tax paid in that year? If an objection is subsequently filed the creditable tax presumably moves from Year 2 credtitable tax to Year 2 creditable tax suspense. If the objection is disallowed in Year 4, the creditable tax presumably then moves into Year 4 creditable tax paid regarding Year 1 with an eighteen month staledating period. If the objection is allowed and the potential refund is left to apply against other current corporate tax liabilities, it presumably now forms part of Year 4 creditable tax.

c. It is frequently the case that a federal assessment of tax will not immediately be matched by a corresponding assessment of Ontario and Quebec provincial corporation income tax. This again raises the possibility of dividend payments being made where the creditable federal and creditable provincial tax will not fall into the usual 80:20 ratio. If more initial assessing is done by those provinces there is a risk that the ratio may, in fact, be reversed. This also suggests that the time for staledating of tax paid as a result of an assessment by one jurisdiction may not coincide with that of another.

Inter-corporate Holdings

35 Creditable tax, as well as arising on payments of tax directly by corporations, would also arise where dividends were received by the corporation from another Canadian corporation. If the paying company were entitled to full integration and the receiving company to half integration, the normal gross-up and credit procedures would be employed, i.e.

Dividend received	$100
Gross up for corporate creditable tax	100
Gross income	$200
Corporate tax	
creditable – 50% x 50%	$ 50
non-creditable – 50% x 50%	50
	$100
Less credit for tax paid by corporation paying dividend	100
Net tax payable	$ 0

The $50 of creditable tax would be added to other creditable tax of the year.

36 If the paying and receiving corporations were entitled to half integration the receiving corporation would pay a special tax of 33-1/3 per cent, all of which would be creditable. This would be accounted for as follows:

Dividend received	$100
Gross up for corporate creditable tax	50
Gross income	$150
Corporate tax	
creditable – 33-1/3%	$ 50
non-creditable	0
	$ 50
Less credit for tax paid by corporation paying dividend	50
Net tax payable	$ 0

Again this $50 of creditable tax would add to the fund of creditable tax for the year in question.

37 This proposed procedure of utilizing a special 33-1/3 per cent fully creditable tax is derived from the basic integration proposal in that it amounts to notionally grossing up the dividend for both creditable and non-creditable tax and then imposing only creditable tax. This can be illustrated as follows:

Dividend received		$100
Gross-up for corporate tax		
creditable	$50	
non-creditable	50	100
Gross income		$200
Corporate tax		
creditable – 50% x 50%		$ 50
non-creditable		n/a
		$ 50
Less credit		50
Net tax payable		$ 0

38 The 33-1/3 per cent tax being fully creditable would be recorded in full in the creditable tax accounts at the time of receipt of an inter-corporate dividend. This would be the case even though the creditable tax flowing with the dividend resulted in no net payment by the receiving corporation. The 2½ year staledating rule would apply to the 33-1/3 per cent tax and would run from the end of the year in which the dividend was received. Rules would presumably be required to prevent the unwarranted freshening of creditable tax by passing dividends through a series of corporations.

39 The 33-1/3 per cent tax being derived from the basic 50 per cent corporate rate (40 per cent federal and 10 per cent provincial) can be segregated for payment and creditable tax accounting purposes as 26.67 per cent federal and 6.66 per cent provincial tax. Thus on an inter-corporate dividend the creditable tax would be accounted for in the following manner.

Advice Slip from Paying Corporation

Dividend paid		$100
Creditable tax –		
federal	$40	
provincial	10	50
Gross income		$150

Receiving Corporation

Gross income		$150
Tax payable federal –		
26.67% x $150	$40 (1)	
Less credit	40	$ 0
Tax payable provincial –		
6.66% x $150	$10 (2)	
Less credit	10	0
Net tax payable		$ 0

(1) carried to creditable federal tax account
(2) carried to creditable provincial tax account

Insufficient Creditable Tax

40 As noted above, the basic theory is to gross up the inter-corporate dividend for both creditable and non-creditable tax and then impose only creditable tax in the receiving corporation. Where the dividend carries full creditable tax the application of the 33-1/3 per cent rate of creditable tax to the dividend grossed up by only creditable tax produces the same result. The application of the 33-1/3 per cent tax to situations where there is less than full creditable tax produces a somewhat different result than that which would be obtained if the basic theory were carried through.

	Base Theory of 25% Creditable 25% Non-creditable Tax	Proposed 33-1/3% Creditable Tax
Corporation 1		
Business income	$200	$200
Corporate tax		
creditable	$ 20	$ 20
non-creditable	20	20
	$ 40	$ 40
After tax earnings	$160	$160
Corporation 2		
Dividend received from Corporation 1	$160	$160
Gross-up for corporate tax		
creditable	20	20
non-creditable	20	n/a
Gross income	$200	$180
Corporate tax		
creditable 25%	$ 50	
– 33-1/3%		$ 60
non-creditable	n/a	n/a
	$ 50	$ 60
Less Credit	20	20
Net tax payable	$ 30	$ 40
After tax receipt	$130	$120
Creditable tax	$ 50	$ 60

Following the original theory of a 50 per cent corporate tax of which 50 per cent would be creditable the business income will have borne the full amount of creditable tax, i.e. 25 per cent of $200 or $50 under the procedure illustrated in column 1. With the application of the 33-1/3 per cent tax the creditable tax has been increased to $60 and the income in the second corporation is fully covered by creditable tax. This is more creditable tax than would have been paid if the business income had borne the full amount of creditable tax (i.e. $50) in Corporation 1.

41 The individual Canadian shareholder of Corporation 2 will be left with the same net after-tax return as if he had received the dividend directly from Corporation 1, however,

there may be a significant difference in the timing of payment of tax by passing the income through Corporation 2. The position of the exempt or non-resident shareholder would be considerably worsened. These factors can be expected to give rise to corporate manoeuvres to obtain the maximum benefit.

42 The Commons Committee proposed that special rules be developed under which tax would not necessarily be paid in a corporation receiving a dividend not fully covered by creditable tax. In certain circumstances the income should flow free of tax within the corporate sector. It is not known whether or to what extent such a procedure will be adopted. The procedures under a system encompassing such a flow-through are summarized later in this study.

Expenses of Earning Dividend Income

43 The following example illustrates the procedure to be followed where the receiving corporation has incurred expenses to earn the dividend income.

Corporation 1	
Business income	$200
Corporate tax	
creditable	$ 50
non-creditable	50
	$100
After tax earnings	$100
Corporation 2	
Dividend received from Corporation 1	$100
Gross-up for corporate tax	
creditable	50
non-creditable	n/a
	$150
Less expenses of earning income	60
Gross income	$ 90
Corporate tax	
creditable — 33-1/3%	$ 30
non-creditable	n/a
	$ 30
Less credit	50
Refund of tax	$ (20)
After tax receipt	$ 60
Creditable tax	$ 30

44 Where there are expenses, such as interest, involved in earning dividend income it can be expected that steps will be taken to attempt to identify those costs with business income in one of the corporations. It can be seen from the above that expenses incurred in a holding company are applied against income on which tax otherwise payable is fully creditable whereas if incurred in the operating company would reduce income subject to both creditable and non-creditable tax. The impact of this can perhaps best be illustrated by utilizing an extreme example where interest and carrying costs are a substantial percentage of net business income.

	Example 1	Example 2	Example 3
Corporation 1			
Net business income	$1,000	$1,000	$1,000
Less interest expense	700	0	0
	$ 300	$1,000	$1,000
Corporate tax	150	500	500
After tax earnings	$ 150	$ 500	$ 500
Corporation 2			
Dividend from Corporation 1		$ 500	
Add creditable tax		250	
		$ 750	
Less interest expense		700	
Gross income		$ 50	
Corporate tax – 33-1/3%		$ 17	
Less credit		250	
Refund		$ (233)	
After tax earnings		$ 33	
Individual Shareholder			
Dividend from corporation	$ 150	$ 33	$ 500
Add creditable tax	75	17	250
	$ 225	$ 50	$ 750
Less interest expense	0	0	700
Gross income	$ 225	$ 50	$ 50
Personal tax – say, 40%	$ 90	$ 20	$ 20
Less credit	75	17	250
Net personal tax (refund)	$ 15	$ 3	$ (230)
After tax receipt	$ 135	$ 30	$ 30

45 It can thus be seen that the maximum advantage is obtained when all costs are incurred in the original corporation rather than being incurred by a corporate or individual shareholder. Where it is not possible to cause the original corporation to incur these costs the impetus for a corporate shareholder will be to attempt to attribute as much as possible of the costs against business rather than dividend income. The effect is illustrated in Table 5.

Table 5

Application of Interest Expense against Dividend or Business Income

	Dividends From Other Corporation	Business Income	Total
Alternative 1			
Income	$1,000	$1,000	$2,000
Interest expense	1,000	0	1,000
Net corporate profit	$ 0	$1,000	$1,000
Add creditable tax	500	0	500
	$ 500	$1,000	$1,500
Corporate tax			
creditable – 33-1/3%	$ 167		
creditable – 25%		$ 250	
non-creditable – 25%		250	
	$ 167	$ 500	$ 667
Less creditable tax with dividend			500
Net tax payable			$ 167
After tax earnings			$ 833
Creditable tax			$ 417
Alternative 2			
Income	$1,000	$1,000	$2,000
Interest expense	0	1,000	1,000
Net corporate profit	$1,000	$ 0	$1,000
Add creditable tax	500		500
	$1,500	$ 0	$1,500
Corporate tax			
creditable – 33-1/3%	$ 500		
creditable – 25 %		$ 0	
non-creditable – 25%		0	
	$ 500	$ 0	$ 500
Less creditable tax with dividend			500
Net tax payable			$ 0
After tax earnings			$1,000
Creditable tax			$ 500

46 The additional after-tax earnings, covered by the maximum creditable tax, which results from attributing interest and other carrying costs against business income rather than dividend income can be expected to prompt corporate taxpayers to attempt to identify borrowings with business rather than investment activity. Thus the present administrative and accounting problems of identifying the use of borrowed money can be expected to continue.

47 At the individual shareholder level a similar situation will prevail. A current deduction of interest and carrying costs will provide the same tax relief whether applied against business or investment income. However, the value of such a deduction will be less if applied against a capital gain, assuming that capital gains will be included in income only to the extent of 50 per cent. Also the white paper prohibition against current investment loss deductions will cause individual Canadian taxpayers to attempt as much as possible to attribute their borrowings to business income.

Corporate Capital Gains and Losses

48 Tax paid on capital gains realized at the corporate level would also give rise to creditable tax. Under the half integration proposals, one corporation realizing a gain on the shares of another would pay a fully creditable tax of 33-1/3 per cent of the gain. (One might question why the fully creditable tax should be 33-1/3 per cent as opposed to the normal effective corporate rate of creditable tax of 25 per cent.) Thus the net after tax gain would carry the maximum amount of creditable tax on distribution to the shareholders. It would not be necessary to separately record such income and tax since it would be treated as any other form of corporate source income and creditable tax on distribution to shareholders. It would, of course, be necessary to identify the federal and provincial portions of such tax both for purposes of payment and for identification of creditable tax.

49 The accounting for capital losses and the computation of any resulting tax relief at the corporate level, as proposed in the white paper, could give rise to complications. Under the proposed system of half integration a capital loss by one corporation on shares of another could only reduce creditable tax but not non-creditable tax. (Tax on such capital gains would be fully creditable, and no non-creditable tax would be paid.) The calculation, which results in a potential tax relief equal to 33-1/3 per cent of the capital loss, provided the corporation has sufficient creditable tax, is illustrated below. It should be noted that it is necessary to gross-up the capital loss by 4/3 in order that the application of the 25 per cent creditable corporate rate provides relief at the 33-1/3 per cent rate.

Corporate business income		$10,000
Loss on shares of another corporation		$ 1,000
Tax potentially recoverable on capital loss – 33-1/3%	$ 333	
Tax payable –		
Non-creditable		
On business income	$10,000	
25% x $10,000		$ 2,500
Creditable		
On business income	$10,000	
Less 4/3 of capital loss	–1,333	
	$ 8,667	
25% x $8,667		2,167
Total tax to be paid of which $2,167 is creditable		$ 4,667

50 If the capital loss were greater than business income, non-creditable tax would be payable but not creditable tax. In addition, some portion of creditable tax previously paid should be recoverable (depending on the capital loss carry over rules) or alternatively a portion of future creditable tax otherwise payable could be offset. This is illustrated as follows:

Corporate business income		$10,000
Loss on shares of other corporations		$12,000
Tax payable –		
Non-creditable		
On business income	$10,000	
25% x $10,000		$ 2,500
Creditable		
On business income	$10,000	
Less 4/3 of capital loss	16,000	
	$ (6,000)	
25% x $6,000	$ (1,500)	
Total tax to be paid – non-creditable.		$ 2,500
Creditable tax recoverable from prior or future years		$ 1,500

Accounting for 33-1/3 per cent and 25 per cent Creditable Tax

51 The mechanics of determining the amount of creditable tax arising from instalment and other payments of tax become more complex in those cases where the corporation pays 33-1/3 per cent creditable tax as well as 25 per cent creditable tax (and non-creditable tax). It was earlier suggested that a monthly instalment of tax could in some instances be divided in the following manner.

Instalment	Non-Creditable Tax	Creditable Federal Tax Year 1	Creditable Provincial Tax Year 1
$5,200	$2,700	$2,000	$500

52 If the corporation receives a dividend from another corporation and is advised that the dividend of $7,000 carries creditable tax of $2,000 ($1,600 federal and $400 provincial), the corporation would be liable for a further tax on the dividend of $1,000. The total of $3,000 would be creditable ($2,400 federally and $600 provincially). If the tax instalment were increased to $6,200 to cover the net additional tax on the dividend the accounting would seem to be as follows:

Instalment		Non-Creditable Tax	Creditable Federal Tax Year 1	Creditable Provincial Tax Year 1
Gross	$8,200	$2,700	$4,400	$1,100
Less credit	2,000			
Net payment	$6,200			

53 The additions to creditable federal tax of $4,400 and to creditable provincial tax of $1,100 would presumably be made in two steps as follows:

	Creditable Federal Tax	Creditable Provincial Tax
At the time of receipt of the dividend	$1,600	$ 400
At the time of payment of the tax	2,800	700
	$4,400	$1,100

54 The creditable tax flowing with an inter-corporate dividend might not always be in the assumed 80:20 federal-provincial ratio. The application of the 33-1/3 per cent tax in the receiving corporation with the resulting additional payments of federal or provincial tax would restore this position. This is illustrated as follows:

	Dividend	Creditable Federal Tax	Creditable Provincial Tax
Dividend covered by maximum creditable tax			
Dividend received	$1,000		
Gross up for creditable tax			
federal $400			
provincial 100	500		
	$1,500		
Tax at 33-1/3%	$ 500	$400	$100
Less credit	500		
Net tax	$ 0		
Dividend covered by less than maximum creditable tax			
Dividend received	$1,000		
Gross up for creditable tax			
federal $208			
provincial 52	260		
	$1,260		
Tax at 33-1/3%	$ 420	$336	$ 84
Less credit	260		
Net tax ($128 federal, $32 provincial)	$ 160		
Dividend covered by less than maximum creditable tax and in other than 80:20 ratio			
Dividend received	$1,000		
Gross up for creditable tax			
federal $330			
provincial 20	350		
	$1,350		
Tax at 33-1/3%	$ 450	$360	$ 90
Less credit	350		
Net tax ($30 federal, $70 provincial)	$ 100		

55 Where additional provincial tax was payable on inter-corporate dividends it would be necessary to provide allocation rules to determine the province or provinces entitled to receive that tax. Should any province impose more than a 6.66 per cent tax on inter-corporate dividends, the additional tax would presumably be non-creditable. A province imposing a general corporate rate of 12 per cent, for example, might decide to apply this effective rate to inter-corporate dividends, thus imposing a tax rate of 8 per cent rather than 6.66 per cent.

56 The 33-1/3 per cent fully creditable tax would apply to a capital gain realized by one corporation on the sale of shares of another. As noted previously, this represents a 26.67 per cent federal rate and a 6.66 per cent provincial rate. Thus if one corporation realized a capital gain of $100 on the sale of shares of another it would pay a tax of $33.33. $26.67 of this tax would be paid to the federal government and treated as creditable federal tax while $6.66 would be paid to the one or more provincial governments affected and treated as creditable provincial tax. It will be necessary to prescribe rules to determine the source of corporate capital gains and the province or provinces entitled to receive the tax. Should any province decide to tax such corporate gains at a rate other than 6.66 per cent or to provide differing rules for the amount or portion of the gain to be taxed or for the timing of recognition of gain then special rules will need to be provided to deal with the determination of creditable tax.

57 As noted previously, it was proposed that a capital loss realized by one corporation on the sale of shares of another would give rise to a reduction or recovery of creditable tax but not of non-creditable tax. The procedure to be employed would be as follows:

	Income	Non-creditable Tax	Creditable Federal Tax	Creditable Provincial Tax
Income from business	$10,000			
Tax payable				
federal – 40%		$2,000	$2,000	
provincial – 12%		700		$500
Capital loss on shares	(1,000)			
Tax relief on 4/3 of loss = $1,333				
federal – 20%			(267)	
provincial – 5%				(66)
	$ 9,000	$2,700	$1,733	$434

58 If the corporation carries on business in more than one province it would allocate its business income among the respective provinces. As noted previously it will be necessary to provide rules concerning the source of capital gains. It will similarly be necessary to

attribute capital losses to particular provinces in order to determine which province or provinces should grant tax relief.

Creditable Foreign Tax

59 In the white paper it was proposed that a limited portion of foreign taxes paid by a Canadian company on foreign dividends and foreign branch profits would qualify as creditable foreign tax for which credit would be allowed to shareholders of the Canadian company. In the case of Canadian shareholders, creditable foreign tax would form part of the creditable tax eligible for gross-up and credit in accordance with the general integration scheme. In the case of non-resident shareholders, creditable foreign tax flowing with dividends received from a Canadian company would apply to reduce or eliminate Canadian withholding tax on the dividends and in some cases the amount of creditable foreign tax could exceed the required amount of withholding tax. Creditable foreign tax would maintain its identity when dividends passed from one Canadian company to another.

60 The foreign taxes qualifying as creditable would include only foreign withholding taxes paid by a Canadian company on foreign dividend income and foreign taxes paid on income derived from a foreign branch. In each case, the creditable foreign tax would be limited to 15/85ths of the net foreign income after deducting all foreign taxes imposed, including withholding taxes. Foreign taxes imposed in excess of 15 per cent would not qualify as foreign creditable tax. Foreign taxes paid on other forms of foreign income of Canadian corporations would also not qualify as foreign creditable tax, nor would foreign corporate income taxes paid by foreign subsidiary companies.

61 Table 6 illustrates, in summary form, the accounting for creditable foreign tax by a Canadian company carrying on business in Canada and receiving dividends from wholly-owned subsidiaries in treaty and non-treaty countries.

Table 6

Accounting for Creditable Foreign Tax on Dividend Income

	Subsidiary in Treaty Country	Subsidiary in Non-treaty Country
Pre-tax profit of subsidiary	$2,000	$1,000
Foreign corporation tax	1,000	300
Net income	$1,000	$ 700
Dividend paid to Canadian parent	$1,000	$ 700
Less withholding tax	150	70
Net dividend received	$ 850	$ 630
Gross-up for foreign taxes	n/a	
Underlying tax		$ 300
Withholding tax		70
		$ 370
Grossed-up dividend for Canadian tax purposes		$1,000
Canadian tax – 50%		$ 500
Less credit for foreign taxes		370
Net Canadian tax		$ 130
Net dividend added to surplus of Canadian company	$ 850	$ 500

Canadian Company –

	Surplus Account	Creditable Federal Tax	Creditable Provincial Tax	Creditable Foreign Tax
Income from Canadian operations	$10,000			
Canadian tax	(5,000)	$2,000	$500	
	$ 5,000			
Gross dividend from treaty country subsidiary	$ 1,000			
Foreign withholding tax	(150)			$150
	$ 850			
Gross dividend from non-treaty country subsidiary	$ 700			
Foreign withholding tax	(70)			70
	$ 630			
Canadian tax	130	15	50	
	$ 500			
Net available for dividends	$ 6,350	$2,015	$550	$220

62 It has been assumed in the above calculation that the federal government will give credit for the total foreign taxes paid against its portion of the corporate tax and that the provinces will need to give credit only where the effective foreign tax rate exceeds 40 per cent. At the moment the federal government and all provinces other than Quebec and British Columbia provide such a tax credit for taxable foreign investment income. On this basis the net tax payable and creditable tax is computed in the following way:

Grossed-up foreign income from non-treaty country subsidiary		$1,000
Federal tax payable –		
Tax at 40%	$400	
Less credit for foreign taxes	370	$ 30
Provincial tax payable –		
Tax at 10%	$100	
Less credit for foreign taxes	0	100
Total tax payable		$ 130
Creditable tax –		
federal 50% x $30		$ 15
provincial 50% x $100		50
Total		$ 65

Recording and Distributing Creditable Foreign Tax

63 It would be necessary for Canadian corporations to maintain a record of their creditable foreign tax separate from their creditable federal and creditable provincial tax. It is understood that dividends from Canadian companies would be grossed up firstly for creditable foreign tax at the rate of 15/85ths of the net amount distributed until the available creditable foreign tax had been exhausted. This would apply to dividends paid to Canadian shareholders as well as to non-residents. Such distributions would be grossed up further by creditable Canadian tax (to the extent available) to provide a combined gross-up of 50 per cent of the net dividend. Here again, creditable Canadian tax would be used in connection with dividends paid to non-residents as well as to residents. When all creditable foreign tax had been exhausted, subsequent dividends would be grossed up by 50 per cent for creditable Canadian tax, until this had been exhausted.

64 For a company having an abundance of all forms of creditable tax on hand, the procedure would be as follows:

Cash dividend to shareholder	$ 85.00
Gross-up for	
creditable foreign tax 15/85ths x $85.00	15.00
creditable federal tax	19.00 (1)
creditable provincial tax	8.50 (2)
Gross income	$127.50

(1) 80% x $42.50 = $34.00 – $15.00 = $19.00
(2) 20% x $42.50 = $ 8.50

65 A Canadian resident individual shareholder would include in his income the $127.50 of gross income and would take credit against his federal tax payable for the creditable foreign and creditable federal tax. He would take credit against his provincial tax payable for the creditable provincial tax.

66 A non-resident would apply the $15.00 of credit for foreign tax against the Canadian withholding tax. Depending on the rate of withholding tax applicable to the dividend the non-resident might be liable for further tax, might have his tax liability totally satisfied or might find that the credit exceeded his Canadian tax liability.

67 It was suggested in the white paper that a company having creditable foreign tax on hand might declare a gross dividend equal to the dividend to be paid plus an amount of creditable foreign tax. The company would treat any creditable foreign tax as a withholding tax which it would retain as a recovery of foreign taxes previously paid. This would apply to both Canadian and non-resident shareholders. The Canadian shareholder would gross-up from the net dividend in computing his income and tax. The non-resident would be liable for withholding tax computed by reference to the gross dividend and against this liability would be applied his portion of the creditable foreign tax. Where the available creditable foreign tax was not sufficient to equal 15/85ths of the dividend to be paid, the gross dividend would presumably be equal to the net dividend plus the shareholder's *pro rata* portion of creditable foreign tax on hand which would therefore need to be known at the time of declaration of the dividend.

68 The following example contrasts the present system with the proposed system and illustrates the utilization of creditable foreign tax. The company is assumed to have both Canadian and foreign source income, has one class of common shares and typically pays 85¢ per share in quarterly dividends. There are two hypothetical shareholders, each holding 100 shares, one a resident of Canada, the other a non-resident. The example has been simplified for illustrative purposes and deals with creditable Canadian tax as a single item rather than dealing separately with federal and provincial tax. It also utilizes a flat 15 per cent withholding tax on dividends to the non-resident shareholder.

	Resident Holder of 100 Shares	Non-Resident Holder of 100 Shares

Present System

Under the present system the payment of 85¢ per quarter on 100 shares of Company X is treated in the following manner:

	Resident Holder of 100 Shares	Non-Resident Holder of 100 Shares
Quarterly dividend	$ 85.00	$ 85.00
Withholding tax – 15%		12.75
Net dividend	$ 85.00	$ 72.25
Canadian tax – say, 40%	$ 34.00	
Less 20% dividend tax credit	17.00	
Net Canadian tax	$ 17.00	$ 12.75

Proposed System – only Canadian income and Canadian creditable tax on hand at the time of payment of the dividend and sufficient creditable tax to cover the dividend.

Under the proposed system the company could continue with its 85¢ quarterly dividend, but would be required to advise Canadian shareholders of the creditable tax flowing with the dividend:

	Resident Holder of 100 Shares	Non-Resident Holder of 100 Shares
Quarterly dividend	$ 85.00	$ 85.00
Withholding tax – 15%		12.75
Net dividend	$ 85.00	$ 72.25
Creditable tax flowing	$ 42.50	$ 42.50
Grossed-up dividend	$127.50	n/a
Canadian tax – say, 40%	$ 51.00	
Less creditable tax	42.00	
Net Canadian tax	$ 8.50	$ 12.75

Proposed System – both Canadian and foreign income and creditable tax on hand at the time of payment of the dividend.

Where the Canadian company suffers a foreign withholding tax on dividend income or pays foreign tax on branch income, it is proposed that such tax be treated as creditable to the extent of 15/85ths of the net foreign income. Foreign creditable tax would flow to all shareholders to the extent of 15/85ths of dividends paid (within the limits of the amount of foreign creditable tax on hand).

Quarterly dividend	$ 85.00	$ 85.00
Creditable tax flow		
foreign 15/85ths x $85	$ 15.00	$ 15.00
Canadian	27.50	27.50
	$ 42.50	$ 42.50

The $15 of creditable foreign tax would form a part of the creditable tax flowing to the Canadian individual shareholder for gross-up and credit purposes with the creditable Canadian tax making up the balance – up to a maximum of 50% of the dividend received. The $15 of creditable foreign tax would satisfy the 15% Canadian withholding tax of the non-resident shareholder.

Proposed System – insufficient creditable tax on hand to cover the dividend

The effect of the proposal to declare a gross dividend equal to the net to be paid plus a portion of creditable foreign tax is illustrated below on the assumption that the two shareholders described are the only shareholders and that the company starts the year with $200 of creditable tax – $150 Canadian and $50 foreign – and does not add to its creditable tax during the year.

i) First quarterly dividend	$ 85.00	$ 85.00
Creditable foreign tax flow 15/85ths of net dividend	15.00	15.00
Gross dividend declared	$100.00	$100.00
Creditable Canadian tax flow	$ 27.50	$ 27.50
Grossed-up dividend of resident	$127.50	
Resident		
Tax on grossed-up dividend – say 40%	$ 51.00	
Less credit	42.50	
Net tax	$ 8.50	
Net after-tax receipt	$ 76.50	
Non-resident		
15% withholding on gross dividend of $100		$ 15.00
Less creditable foreign tax		15.00
Net tax to be withheld		$ 0
Net after Canadian tax		$ 85.00

	Resident Holder of 100 Shares	Non-resident Holder of 100 Shares
ii) Second quaterly dividend ($115 of creditable tax remaining – $95 Canadian and $20 foreign)	$ 85.00	$ 85.00
Creditable foreign tax flow – limited to amount on hand	10.00	10.00
Gross dividend declared	$ 95.00	$ 95.00
Creditable Canadian tax flow	32.50	$ 32.50
Grossed up dividend of resident	$127.50	
Resident		
Tax on grossed-up dividend – say 40%	$ 51.00	
Less credit	42.50	
Net tax	$ 8.50	
Net after tax receipt	$ 76.50	
Non-resident		
15% withholding on gross dividend of $95		$ 14.25
Less creditable foreign tax		10.00
Net tax to be withheld		$ 4.25
Net after Canadian tax		$ 80.75
iii) Third quaterly dividend ($30 of creditable tax remaining – all Canadian)	$ 85.00	$ 85.00
Creditable foreign tax flow	0	0
Gross dividend declared	$ 85.00	$ 85.00
Creditable Canadian tax flow – limited to amount on hand	$ 15.00	$ 15.00
Grossed up dividend of resident	$100.00	
Resident		
Tax on grossed up dividend – say 40%	$ 40.00	
Less credit	15.00	
Net tax	$ 25.00	
Net after tax receipt	$ 60.00	

Non-resident

15% withholding on gross dividend of $85	$ 12.75
Less creditable foreign tax	0
Net tax to be withheld	$ 12.75
Net after Canadian tax	$ 72.25

69 One of the problems with this concept is the proposal to declare a gross dividend (i.e. net to be paid plus creditable foreign tax) when the intention is to pay a lesser amount of actual dividend. Since creditable foreign tax will flow with the first dividend paid (to the extent of 15/85ths) it will be necessary that the directors be aware of the amount of creditable foreign tax on hand at the time of declaring a dividend. The gross declaration could turn out to be the wrong amount should the company incur further creditable foreign tax between the time of declaration of the dividend and its actual payment to the shareholders. It may be possible to deal with this problem in the case of common shares by declaring "formula dividends" i.e. dividends of a cash sum plus the shareholder's pro rata portion of creditable foreign tax on hand up to 15/85ths of the cash payment. Some alternative procedure would seem to be necessary to deal with dividend payments on preference shares and interest payments on income debentures. These payments are generally fixed in amount and would not be expected to fluctuate with amounts of creditable foreign tax. Additional practical problems can be contemplated if the initial intention had been to pay the net dividend as a stock dividend.

Creditable Foreign Branch Tax

70 Foreign tax paid on branch profits of a Canadian corporation would be creditable to the extent of 15/85ths of the net branch profits. It is not known how the amount of such creditable tax would be determined in practice and answers will be needed to the following questions:

- For purposes of the 15/85ths limitation will profits need to be determined under Canadian tax rules or is the amount of profit (converted to equivalent Canadian dollars) actually subjected to foreign tax to be used?
- Is a portion of each instalment payment of foreign tax to be considered to be creditable? If so, to what amount is the 15/85ths limitation applied?
- What rules are to be prescribed to deal with assessments and appeals arising in the foreign country?

- what happens if the foreign tax paid had been carried out to shareholders with dividends as creditable foreign tax and is subsequently recovered because of overpayments of current instalments or the carryback of subsequently incurred losses?

Shareholders Receiving Dividends Carrying Creditable Foreign Tax and Creditable Canadian Tax

71 Canadian shareholders receiving a dividend would gross-up from the amount of the net dividend (i.e. the gross dividend declared less the creditable foreign tax withheld) for both creditable foreign tax and creditable Canadian tax. They would take credit for all forms of creditable tax in determining their net tax liability. In certain circumstances this could result in net refunds, particularly to lower income shareholders. These refunds could arise solely from creditable foreign tax where no Canadian corporate tax had been paid. Where the shareholder was an exempt Canadian institution the creditable Canadian tax would nevertheless flow from the company but would not be refunded. Thus it would be wasted. It is not clear whether or not the amount withheld from the gross dividend in respect of creditable foreign tax would be refundable to the exempt Canadian recipient or whether his entitlement would be limited to the net dividend received.

72 Non-resident shareholders would presumably be entitled to receive the gross dividend declared by the company less the appropriate rate of withholding tax with the creditable foreign tax applying to satisfy in full or in part their withholding tax liability. For foreign shareholders liable to the proposed general rate of withholding of 25 per cent there would always be some net further withholding to satisfy their Canadian tax liability. Foreign shareholders liable to a 15 per cent Canadian tax could have their liability fully satisfied by the application of creditable foreign tax or could be liable to a net withholding. Foreign shareholders who were eligible for a 10 per cent withholding because of the company having a degree of Canadian ownership or liable to no Canadian tax because of a treaty exemption (e.g. U.S. charities) would frequently be entitled to receive a greater amount as a gross dividend than the company intended to pay as a net dividend. It is not clear whether the company would pay the gross dividend less the appropriate withholding and recover any excess payment from the federal government or if the company would pay only the net dividend leaving the federal government to account directly to the foreign shareholder for his creditable foreign tax entitlement. If foreign governments are to accept that their taxpayers' foreign source income is the gross amount of the dividend and that they have in fact incurred a foreign (i.e. Canadian) tax then the former procedure of a gross payment by the Canadian company would seem to be required. Creditable Canadian tax would flow with dividends to non-resident shareholders but would be totally ignored in determining their Canadian tax liability and thus would be wasted.

73 Canadian shareholders would receive credit for creditable foreign tax only to the extent of 15/85ths of the net dividend. It is thus possible that a Canadian company could have enough creditable tax in total to fully cover a dividend but because of the nature of the creditable tax it could not fully flow to the shareholders. For example:

Accumulated earnings of corporation	$100.00
Creditable tax –	
foreign	25.00
Canadian	25.00
	$ 50.00
Dividend to shareholder (net)	$100.00
Creditable foreign tax – 15/85ths x $100	17.65
Gross dividend	$117.65
Creditable Canadian tax – $50.00 – 17.65 = $32.35 but limited to amount on hand of	25.00
Gross income	$142.65

This would leave $7.35 of creditable foreign tax in the company but with no earnings available to carry it out to the shareholders. These problems of wasting creditable tax on exempt persons, wasting creditable Canadian tax on non-residents and locking in existing creditable tax may be expected to lead to various corporate arrangements designed to maximize the use of creditable tax for the benefit of shareholders. Such a procedure is described in the attached Appendix.

Individuals and Corporations not Resident in, or Having Income Allocated to Other than a Prescribed Province

74 At the present individuals who are resident in the Yukon and the Northwest Territories or who are abroad but are deemed to be resident in Canada pay federal income tax without provincial abatement and are not liable for provincial income tax. Under the white paper proposals which discontinue the general provincial abatement and produce a net federal tax rate schedule, such persons would be liable to a federal surtax corresponding to the provincial tax. Presumably, creditable provincial tax flowing with dividends to these people would apply to reduce this surtax and the federal government would absorb the cost of the credit.

75 Similarly, it may be expected that corporations allocating some or all of their income to the territories would treat a portion of their federal tax as creditable provincial tax for purposes of reporting to their shareholders. This might be done in the following way:

Total Income		$10,000	
Ontario portion	40%		
Territories portion	60%		
	Non-creditable Tax	Creditable Federal Tax	Creditable Provincial Tax
Ontario income			
Federal tax – 40%	$ 800	$ 800	
Ontario tax – 12%	280		$ 200
Territories income			
Federal tax – 50%	1,500	1,200	300

76 The provinces would then be expected to give credit to the shareholders of the corporation against their individual income tax for this "territories – provincial" tax.

77 It is not known whether or not a similar procedure might be intended to deal with the tax on business profits of Canadian corporations earned in foreign branch operations. A Canadian corporation having a branch in the United States, for example, would pay Canadian federal tax on those branch profits with credit for U.S. taxes paid. Under present rules those profits would not be subject to provincial corporation tax since they are attributable to a permanent establishment outside of the provinces. It is possible that the corporation may have no Canadian business establishment.

78 A Canadian company earning $10,000 in a U.S. branch would face U.S. tax of approximately $2,200. Canadian tax at 50 per cent and after credit for the U.S. tax, would be $2,800, of which $1,400 would be creditable ($1,376 – being 15/85ths of $7,800 – of the U.S. tax would also qualify as creditable foreign tax). To make the system workable, it presumably would be intended that some part of the $1,400 of creditable tax (perhaps in the typical 40:10 ratio) should be treated as creditable provincial tax.

79 Should the above company pay out its total after-tax earnings of $5,000 as a dividend, creditable foreign tax would flow to the extent of 15/85ths of the dividend or $882 and the $1,400 of creditable Canadian tax would totally flow leaving the dividend not fully covered with the maximum ($2,500) creditable tax. Thus an individual Canadian shareholder would report his share of the gross income of:

Cash dividend	$5,000
Creditable foreign tax	882
Creditable Canadian tax	1,400
	$7,282

and pay tax on this figure. If he is to treat some part of the $1,400 as creditable against his provincial tax then some procedure will need to be devised under which the corporation may determine the amount to be reported to him.

Mining Companies

80 The accounting for creditable tax by mining companies may be more complex than for non-mining companies since many companies earning mining profits would also earn non-mining profits as well. Some would be in receipt of dividends or realizing capital gains and thus would need to account for the special fully-creditable 33-1/3 per cent tax or for creditable foreign tax.

81 Under the revised proposals for the mining industry, the federal tax on mining profits is to be abated by 25 percentage points to a net of 25 per cent. It would seem that this could give rise to two possibilities as regards creditable tax. Firstly, the federal government may wish to continue the general 40:10 federal-provincial ratio and thus give credit for 20 percentage points of its net 25 per cent tax, leaving the provinces to give credit for 5 percentage points of creditable tax regardless of the level of their income tax. Alternatively, 50 per cent of the 25 per cent could represent creditable federal tax and 50 per cent non-creditable tax.

82 Until the provinces determine their position regarding the detailed taxation of mining profits, it is not possible to determine what rules might be appropriate concerning provincial creditable tax. Should any province increase its corporate income tax on mining profits to 25 per cent or more then it would seem logical that 50 per cent of the 25 per cent rate be treated as creditable tax. This would give rise to the possibility of differing amounts of creditable tax arising because of differing provincial rules. The more likely possibility would seem to be that the federal government will give credit for 20 percentage points of creditable tax and the provinces for 5 percentage points. It is not expected that any portion of the mining tax would be considered to be creditable.

83 Some potential alternatives and assumptions are summarized in the following table using the general assumption of 20 per cent creditable federal tax and 5 per cent creditable provincial tax. It has also been assumed that the provincial mining taxes will cease to be deductible in determining income subject to tax as was proposed by the federal government. The table has been simplified by treating the provincial mining tax base as being the same as the income tax base (for other than depletion) although this would rarely be the case.

Table 7

Some Alternative Procedures for Taxing Mining Profits

	Provincial Income and Mining Tax Base in Agreement with Federal Income Tax Base	Province Substitutes 15% Income Tax for Mining Tax	Province Increases Income Tax to 27% and Continues Mining Tax
NO EARNED DEPLETION AVAILABLE			
Mining profits	$100.00	$100.00	$100.00
Taxable income	$100.00	$100.00	$100.00
Federal income tax – 25%			
creditable	$ 20.00	$ 20.00	$ 20.00
non-creditable	5.00	5.00	5.00
	$ 25.00	$ 25.00	$ 25.00
Provincial income tax – 12%			
creditable	$ 5.00	$ 5.00	$ 5.00
non-creditable	7.00	22.00	22.00
	$ 12.00	$ 27.00	$ 27.00
Provincial mining tax – 15%			
non-creditable	$ 15.00	$ 0	$ 15.00
Total taxes			
creditable	$ 25.00	$ 25.00	$ 25.00
non-creditable	27.00	27.00	42.00
	$ 52.00	$ 52.00	$ 67.00
MAXIMUM EARNED DEPLETION AVAILABLE			
Mining profits	$100.00	$100.00	$100.00
Less depletion	33.33	33.33	33.33
Taxable income	$ 66.67	$ 66.67	$ 66.67
Federal income tax – 25%			
creditable	$ 13.33	$ 13.33	$ 13.33
non-creditable	3.33	3.33	3.33
	$ 16.66	$ 16.66	$ 16.66
Provincial income tax – 12%			
creditable	$ 3.33	$ 3.33	$ 3.33
non-creditable	4.67	14.67	14.67
	$ 8.00	$ 18.00	$ 18.00
Provincial mining tax – 15%			
non-creditable	$ 15.00	$ 0	$ 15.00
Total taxes			
creditable	$ 16.66	$ 16.66	$ 16.66
non-creditable	23.00	18.00	33.00
	$ 39.66	$ 34.66	$ 49.66

84 Should some of the provinces not adopt an income tax base which is identical to that of the federal government, rules would be necessary to determine the appropriate amount of provincial tax to be treated as creditable. In such a situation, it is not known whether 5 per cent creditable provincial tax would be 5 per cent of the federal taxable income or 5/12ths of the provincial tax levy (assuming a 12 per cent corporate tax rate in the particular province).

Instalment Payments of Tax

85 Instalment payments of tax are generally in round amounts and based on the experience of the preceding year. (In fact, present income tax law permits the first two federal instalments to be based on the results of the second preceding year.) Adjustments to arrive at the actual tax are made later in the year or on filing the corporate tax return. If it is necessary that corporations analyse each tax instalment to identify on some preliminary basis the fully creditable, partly creditable and non-creditable tax elements it will create considerable complexity. From a corporate point of view, it would be logical to attempt to maximize initial credits to creditable tax accounts by arguing that tax instalments cover firstly the net tax on inter-corporate dividends and tax on share gains (fully creditable) while secondly covering tax on business profits (partly creditable) and further that no recognition was taken of share losses in computing the amount of instalment payments. It is not known whether such treatment would be acceptable.

86 The example shown in Table 8 illustrates the computation of taxable income, tax payable and creditable tax and demonstrates the difficulty of identifying the amount of creditable tax on a current basis. It is assumed that the current income allocation rules would apply to all corporate source income, that provincial corporate tax rates would continue at present levels and that they would apply to all corporate source income, i.e. to business profits, dividends and capital gains in the manner outlined previously.

87 In order to simplify the example, it is assumed that the corporation does not have foreign source income or foreign shareholders, is not engaged in the fields of mining or oil and gas, carries on business in only two provinces (current sales/wage ratio 60:40), pays its Ontario capital tax as a separate deductible item, has only a minor number of adjustments between financial and taxable income and has dividends from other Canadian corporations which carry creditable tax in the 80:20 ratio. For ease of calculations most amounts are shown in even thousands of dollars.

Table 8

Computation of Taxable Income, Tax Payable and Creditable Tax

Corporation X

Income shown on financial statements		
Business profits		$100,000
Dividend income		11,000
Capital gain on sale of shares		3,000
		$114,000
Provision for taxes on income		
– current	$47,000	
– deferred	10,000	57,000
Net profit for year		$ 57,000
Taxable income		
Business profits		$100,000
Expenses not deductible in determining taxable income		5,000
Capital cost allowance claimed in excess of depreciation written		(20,000)
Taxable business profits		$ 85,000
Dividends from other Canadian corporations		$ 11,000
Creditable tax		4,000
Taxable amount		$ 15,000
Capital gain on shares of other Canadian corporations		$ 3,000
Total taxable income		$103,000

Table 8 (cont'd)

Computation of Taxable Income, Tax Payable and Creditable Tax

		Tax			
				Creditable	
		Total	Non-Creditable	Federal	Provincial
Tax payable – federal					
On business profits					
40% x $5,000		$ 2,000	$ 2,000		
40% x $80,000		32,000	16,000	$16,000	
On capital gain					
80% x 33-1/3% x $3,000		800		800	
On dividends					
80% x 33-1/3% x $15,000	$4,000			4,000(1)	
			$18,000	$20,800	
Less credit 80% x $4,000..........	3,200	800			
Net tax to pay		$35,600			
Tax payable – Manitoba					
On business profits					
13% x 40% x $5,000		$ 260	$ 260		
13% x 40% x $80,000		4,160	2,560		$1,600
On capital gain					
26% x 40% x 33-1/3% x $3,000 (2)		104	24		80
On dividends					
26% x 40% x 33-1/3% x $15,000 (2).	520				
			120		400(1)
			$2,964		$2,080
Less credit 40% x 20% x $4,000	320	200			
Net tax to pay		$ 4,724			
Tax payable – Ontario					
On business profits					
12% x 60% x $5,000		$ 360	$ 360		
12% x 60% x $80,000............		5,760	3,360		$2,400
On capital gain					
24% x 60% x 33-1/3% x $3,000 (3)		144	24		120
On dividends					
24% x 60% x 33-1/3% x $15,000 (3) .	$ 720				
			120		600(1)
			$ 3,864		$3,120
Less credit 60% x 20% x $4,000	480	240			
Net tax to pay		$ 6,504			
Totals		$50,828	$24,828	$20,800	$5,200
Less credit		4,000			
Net tax to pay		$46,828			

(1) The creditable tax flowing with the dividend would be creditable on receipt of the dividend whereas payment of the additional tax would give rise to creditable tax only when the payment was made.

(2) 13/10 x 20% = 26%

(3) 12/10 x 20% = 24%

88 If one could know at the beginning of a year that the above figures would represent the results of the year's operations and the tax thereon, then it would seem logical that the corporation would pay monthly instalments on account of federal and Manitoba tax of $3,400 and bi-monthly instalments of $1,100 to Ontario. It could also be determined that of the $3,400, on a pro rata basis – approximately $1,750 is non-creditable, $1,500 is creditable federal tax and $150 is creditable provincial tax. Of the $1,100 payment to Ontario, approximately $650 is non-creditable and $450 is creditable.

89 Obviously, however, corporations do not have this information available when making early instalments of tax and many will not have it available much before the time for filing their tax returns, i.e. six months after the year-end or seventeen months after their first instalment of tax was due. If each corporation is to estimate the creditable tax portion of each instalment of tax, some will be exact, many will be close, some will be extremely inaccurate – and a few may not even try. Yet accurate information will be essential and shareholders whether they be individuals, trusts or other corporations, residents or non-residents will need to be able to rely on the information provided to them by the corporation.

Provinces not Party to the Collection Agreement for Personal Income Tax

90 At the moment the province of Quebec is the only Canadian province not party to the federal-provincial collection agreement for its personal income tax. As discussed earlier in this analysis the proposed federal personal income tax rate structure would not provide for a general tax abatement for provincial tax but would be structured on a net basis with the collection-agreement provinces free to apply their tax at whatever percentage of the federal tax they should wish. This could be at a rate of 28 per cent (i.e. the present federal abatement for provincial tax) or any other percentage the province might choose.

91 To recognize the additional programs which the province of Quebec has assumed and the resultant increased Quebec personal income tax, the federal abatement for Quebec is currently 50 per cent. On the assumption that Quebec will continue to levy its own personal income tax and recognizing that other provinces might also assume further cost responsibilities which would necessitate a change in the rate schedule, the federal government proposed a continuation of the abatement system for such costs.

92 A taxpayer resident in a province for which a further abatement of 22 per cent was provided could compute his tax in the following way:

Federal taxable income	$100.00
Federal tax	$ 25.00
Less provincial abatement – 22%	5.50
	$ 19.50
Provincial taxable income	$100.00
Provincial tax	$ 13.00
Total tax	$ 32.50

93 If the taxable income was totally dividends from Canadian corporations carrying the maximum creditable tax the computation could be made in the following way:

Federal taxable income after gross-up	$150.00
Federal tax	$ 38.00
Less provincial abatement – 22%	8.36
	$ 29.64
Less credit for corporate tax	40.00
Net federal refund	$ 10.36
Provincial taxable income after gross-up	$150.00
Provincial tax	$ 25.00
Less credit for corporate tax	10.00
Net provincial tax	$ 15.00
Total tax (net)	$ 4.64

94 If the province decided not to adopt the integration proposal the tax might be computed in the following way:

	With 10% Provincial Dividend Tax Credit	With No Provincial Dividend Tax Credit
Federal taxable income after gross-up	$150.00	$150.00
Federal tax	$ 38.00	$ 38.00
Less provincial abatement – 22%	8.36	8.36
	$ 29.64	$ 29.64
Less credit for corporate tax	40.00	40.00
Net federal refund	$ 10.36	$ 10.36
Provincial taxable income	$100.00	$100.00
Provincial tax	$ 13.00	$ 13.00
Less dividend tax credit	10.00	—
Net provincial tax	$ 3.00	$ 13.00
Total tax (refund)	$ (7.36)	$ 2.64

95 It does not appear that it is intended to vary the normal 80:20 ratio for dealing with creditable tax to recognize the further provincial abatement. While the cost of the present 20 per cent dividend tax credit is shared federal – provincially in the personal income tax ratio, for example

Ontario	–	approximately 78:22
Manitoba	–	approximately 72:28

the sharing of the credit for corporate tax would continue in the 80:20 ratio, viz. in the corporate tax ratio.

Changes in Corporate Tax Participation

96 Should the provinces move in time to a greater participation in the corporate income tax the creditable tax components would need to be varied. For example, if the federal corporate tax abatement were to be increased to 15 per cent, the creditable tax calculation by a corporation carrying on business in a province levying a 17 per cent tax would be as follows:

Tax payable on corporate profits of $100	$52.00
Consisting of –	
Non-creditable tax	$27.00
Creditable federal tax 50% x $35	17.50
Creditable provincial tax 50% x $15	7.50
	$52.00

97 The 33-1/3 per cent fully creditable tax would then consist of 23-1/3 per cent creditable federal tax and 10 per cent creditable provincial tax. Transitional rules would be necessary to deal with creditable tax accumulated in the 80:20 ratio and moving on to the 70:30 era.

Start-Up Provisions

98 Since the proposed system of integration would be totally new and would commence on a given date, it would be necessary to provide special transitional rules to deal with earnings accumulated under the present system which were distributed by way of dividends to shareholders under the new system. The general proposal was to permit corporations to elect to pay a special 15 per cent tax on all or part of their accumulated surplus. This tax would be withheld from dividends to all shareholders, resident, non-resident or exempt. For the resident shareholder, there would be no further tax liability (and no refund of tax). However, the amount of the gross dividend (i.e. the amount before withholding tax) would be considered to be a return of capital and applied to reduce the cost basis of his shares of the company for purposes of determining subsequent capital gain or loss. For a non-resident

shareholder the 15 per cent withholding tax would be treated as applying against his liability for withholding tax and he could be liable for further tax or could be entitled to a refund of tax depending upon the withholding rate in effect at the time.

99 It is understood that this 15 per cent tax would apply to undistributed income and not to other forms of surplus; that it would effectively deal with any existing designated surplus, and that it would apply to presently exempt inter-corporate dividends paid out of control period earnings.

100 Because the fiscal year-end of many corporations would not coincide with the date of implementation of the new system, it would also be necessary to provide transitional procedures to deal with the determination of creditable tax for taxation years in progress. The proposal in the federal government technical paper of March 19, 1970 can perhaps be best illustrated in chart form as follows:

If implementation day coincides with the end of month	Then on the date each subsequent instalment falls due apply the following fraction to the total tax payments to that date when determining the amount of creditable tax.									
	2	3	4	5	6	7	8	9	10	11	12
1	1/2	2/3	3/4	4/5	5/6	6/7	7/8	8/9	9/10	10/11	11/12
2		1/3	2/4	3/5	4/6	5/7	6/8	7/9	8/10	9/11	10/12
3			1/4	2/5	3/6	4/7	5/8	6/9	7/10	8/11	9/12
4				1/5	2/6	3/7	4/8	5/9	6/10	7/11	8/12
5					1/6	2/7	3/8	4/9	5/10	6/11	7/12
6						1/7	2/8	3/9	4/10	5/11	6/12
7							1/8	2/9	3/10	4/11	5/12
8								1/9	2/10	3/11	4/12
9									1/10	2/11	3/12
10										1/11	2/12
11											1/12

101 It was suggested that this estimate of creditable tax could be adjusted to the precise amounts when the tax return for the year was filed. Presumably rules will be provided which will describe what is to be done where shareholders have been advised of an incorrect amount of creditable tax, either too much or too little.

102 It would seem that tables similar to the above will need to be provided to deal with direct provincial corporate tax payments. In addition, modified tables will be necessary for those corporations who might have less than a twelve-month year in progress on implementation day or who decide subsequently to terminate the year prior to its running its normal span of twelve months.

Commons Committee Proposal for Free Flow of Inter-corporate Dividends

103 The Commons Committee proposed that dividends should flow from one Canadian corporation to another without the payment of tax under certain circumstances. In any case where the receiving corporation held a direct investment (i.e. 25 per cent or more of the shares of the payor corporation) the dividend should be free of tax regardless of whether or not it bore sufficient creditable tax. In the case of portfolio investments the dividends should flow freely only if a deficiency of creditable tax arose because of the provision of particular corporate level incentives. (The Commons Committee also proposed that dividends from widely-held Canadian companies received by closely-held Canadian companies generally be subjected to a 50 per cent fully creditable corporate tax as a method of dealing with the personal corporation problem.) The following table illustrates the procedure under which the Commons Committee proposal might work. In this example the income is shown as flowing only between two corporations. Where the free flow was available only because of the existence of a particular corporate level incentive, rules would be necessary to identify the income should it pass through a series of more than two corporations.

Table 9

Illustration of the Commons Committee Proposal for Free Flow of Inter-corporate Dividends

	Corporate Direct Investment		Corporate Portfolio Investment		
	Sufficient Creditable Tax	Insufficient Creditable Tax	Sufficient Creditable Tax	Insufficient Creditable Tax–due to "Flow-through" Incentives	Insufficient Creditable Tax–due to Other Reasons
Inter-corporate dividend	$ 100	$ 100	$ 100	$ 100	$ 100
Creditable tax	50	20	50	15	20
Gross income	$ 150	$ 120	$ 150	$ 115	$ 120
Tax – 33-1/3%	$ 0	$ 0	$ 50	$ 15 (1)	$ 40
Less credit			(50)	(15)	(20)
Tax payable by receiving corporation	$ 0	$ 0	$ 0	$ 0	$ 20
After-tax receipt	$ 100	$ 100	$ 100	$ 100	$ 80
Creditable tax	$ 50	$ 20	$ 50	$ 15	$ 40
Basis of share valuation					
Original basis of share valuation – say	$1,000	$1,000	$1,000	$1,000	$1,000
Adjustment due to insufficient creditable tax (2)		60		70	
Revised basis	$1,000	$ 940	$1,000	$ 930	$1,000

(1)Tax is calculated as follows:		
Dividend received	$ 100	
Less portion not bearing creditable tax	70	
Net dividend subject to tax	$ 30	
Add creditable tax	15	
Income subject to tax	$ 45	
Tax – 33-1/3%	$ 15	
(2)Maximum creditable tax	$ 50	$ 50
Actual creditable tax	20	15
Deficiency	$ 30	$ 35
Cost basis adjustment (2 x deficiency)	$ 60	$ 70

ILLUSTRATION OF CANADIAN CORPORATE TAX COMPUTATION AND INTEGRATION OF CORPORATE AND SHAREHOLDER TAX

The following schedules are intended to illustrate the position of a Canadian company – Company X – under the system proposed for taxing Canadian corporations and integrating the corporate tax with the shareholder tax. Table A-1 sets out a summary calculation indicating the source of income of Company X which comprises income from Canadian operations carried on directly, income earned in Canada by Canadian subsidiaries and income earned in foreign countries by various foreign subsidiaries. Table A-1 sets out a possible dividend flow to Company X from its subsidiaries and from Company X to its various classes of shareholders. It is assumed that Company X has an annual dividend requirement of $10,000 on its preference shares and pays a $25,000 dividend on its common shares. The calculations are shown in summary form on an annual basis. In actual practice the computations would need to be made each time a dividend was paid in order to establish the amount of creditable tax on hand and the flow of that tax to the shareholders. Creditable Canadian tax is shown as the aggregate of both federal and provincial tax.

Table A-1

COMPANY X

Illustration of Canadian Corporate Tax Computation and Integration of Corporate and Shareholder Tax

	Company X			Source of Income				Shareholders			
						Foreign Subsidiaries					
	Surplus Account	Creditable Canadian Tax	Creditable Foreign Tax	Direct Canadian Operations	Canadian Subsidiaries	Treaty Countries	Non-Treaty Countries	Other Canadian Corporations	Canadian Individuals	Exempt Canadian Entities	Foreign Persons
Balance of retained earnings	$58,500	$10,000	$1,500		$25,000	$15,000	$10,000				
Earnings of year before tax				$50,000	$20,000	$10,000	$12,000				
Corporate tax				(20,000)	(8,000)	(5,000)	(3,000)				
After tax earnings				$30,000	$12,000	$ 5,000	$ 9,000				
Direct Canadian earnings	30,000	10,000		(30,000)							
Dividends from – Canadian subs. (1)	6,000	3,000			(6,000)						
Foreign subs. – treaty (2)	1,700		300			(2,000)					
–non-treaty (3)	2,000	275	450				(3,000)				
					$ 6,000	$ 3,000	$ 6,000				
	$98,200	$23,275	$2,250		$31,000	$18,000	$16,000				
Dividends paid to shareholders of X											
Preference	$10,000							$ 850	$6,600	$1,700	$ 850
creditable foreign tax			(4)$1,765					150	1,165	(6) 0	150
creditable Cdn. tax		(5)$ 3,235						275	2,135	(7) 0	(8) 0
Common	25,000							10,000	7,000	3,000	5,000
creditable foreign tax			(9) 485					194	136	(11) 0	(13) 97
creditable Cdn. tax		(10)12,015						4,806	3,364	(12) 0	(14) 0
	$35,000	$15,250	$2,250								
Balance	$63,200	$ 8,025	$ 0		$31,000	$18,000	$16,000				

NOTES TO TABLE A-1

(1)	Receipt by X		\$6,000
	Gross-up for creditable tax		3,000
			\$9,000
	Tax at 33-1/3% – fully creditable		\$3,000
	Less credit		3,000
	Net tax to X		\$ 0
(2)	Dividend payment		\$2,000
	Less foreign withholding tax – 15% fully creditable		300
	Net receipt by X (exempt)		\$1,700
(3)	Dividend payment		\$3,000
	Less foreign withholding tax – 15% fully creditable		450
	Net receipt by X		\$2,550
	Gross-up for foreign tax		
	– withholding	\$ 450	
	– underlying	1,000	1,450
			\$4,000
	Canadian tax – 50%		\$2,000
	Less credit for foreign tax		1,450
	Net Canadian tax		\$ 550
	After tax receipt		\$2,000
	Creditable tax		
	Foreign		\$ 450
	Canadian 50% x \$550 =		\$ 275

(4) 15/85 of \$10,000 to the extent of creditable foreign tax on hand

(5) 50% of \$10,000, less \$1,765

(6) \$300 of creditable foreign tax would flow with dividend – no effect on exempt Canadian entity

(7) \$550 of creditable Canadian tax would flow with dividend – no effect on exempt Canadian entity

(8) \$275 of creditable Canadian tax would flow with dividend – no effect on non-resident shareholder

(9) 15/85 of \$25,000 to the extent of creditable foreign tax on hand

(10) 50% of \$25,000, less \$485

(11) \$58 of creditable foreign tax would flow with dividend – no effect on exempt Canadian entity

(12) \$1,442 of creditable Canadian tax would flow with dividend – no effect on exempt Canadian entity

NOTES TO TABLE A-1 (cont'd)

(13) $97 of creditable foreign tax would flow with dividend –

Dividend	$5,000
Gross-up	97
	$5,097
Canadian withholding –	
15% x $5,097	$ 765
Less creditable tax	97
Net withholding	$ 668
Net dividend	$4,332

(14) $2,403 of creditable Canadian tax would flow with dividend –
no effect on non-resident shareholder –
cannot be offset against withholding on dividend

COMPANY X
COMMENTS ON TABLE A-1

1 Dividends to other Canadian corporations and to Canadian individuals are fully covered by creditable tax.

2 Dividends flowing to Canadian exempt entities carry creditable tax with them even though such tax is of no benefit to the receiving shareholder. In the illustration set out in Table A-1, $358 of creditable foreign tax and $1,992 of creditable Canadian tax is, therefore, unused. This assumes that exempt Canadian shareholders will receive only the net dividend and will not receive the creditable foreign tax.

3 Foreign shareholders receive credit for their proportionate amount of the creditable foreign tax which in the case of the preference shareholders fully satisfies the Canadian withholding tax requirement. In the case of the common shareholders there is an actual withholding of $668 since there is insufficient creditable foreign tax on hand to meet the withholding tax requirement. While Company X has had creditable foreign tax aggregating $2,250 during the year most of this has been carried out to the Canadian shareholders where it is treated in the same way as creditable Canadian tax. There is creditable Canadian tax still on hand in Company X but this cannot be used to offset the withholding tax on dividends to foreign holders of the common shares. In fact, a portion of the creditable Canadian tax is considered to flow to the foreign common shareholders but they receive no benefit from it.

4 The directors of Company X might consider drawing further income from one or more of the foreign subsidiaries in order to cause a foreign withholding tax to be imposed and thus permit a flow-through of this tax to the foreign shareholders. In order to provide sufficient creditable foreign tax to totally eliminate the withholding of $668 from dividends to the foreign common shareholders it would be necessary that there be $4,413 of creditable foreign tax on hand at the time of paying the common share dividend (15/85ths x $25,000 = $4,413). This could have been accomplished by withdrawing the $18,000 of accumulated earnings from the foreign subsidiaries in treaty countries and $8,200 from the foreign subsidiaries in non-treaty countries. This would have cost Company X $5,434 in additional current taxes, as illustrated below.

Creditable foreign tax –	
On hand	$ 485
15% on $18,000	2,700
15% on $ 8,200	1,230
	$4,415

Tax cost to Company X –			
On $18,000 – foreign withholding tax			$2,700
On $ 8,200 – foreign withholding tax		$1,230	
Canadian tax on	$8,200		
+ gross-up for under-lying foreign corporate tax (25%)			
$\frac{\$ 8,200}{\$16,000}$ x $5,333[1]	2,733		
	$10,933		
50% of tax	$ 5,467		
Less credit for foreign tax			
$1,230			
2,733	3,963	1,504	2,734
			$5,434

[1]25/75 x $16,000 = $5,333

COMPANY X
POSSIBLE FORM OF CORPORATE REORGANIZATION TO ACCOMMODATE TO PROPOSED TAX SYSTEM

The directors of Company X might consider a reorganization along the following lines in order to provide their various classes of shareholders with the maximum advantage under the proposed system without at the same time penalizing either the corporation itself or other classes of shareholders.

Company X might be turned into a holding company carrying on no operations directly itself. The existing direct Canadian operations could be transferred to an existing or new Canadian subsidiary.

Each existing common share might be exchanged for one new Class A, Class B or Class C common share. All common shares would be freely inter-changeable from one to the other and all would be entitled to the same amount of annual dividend.

The directors of the company might agree and provide in a prospectus or information circular that to the maximum extent possible dividends would be paid in the following manner:

1. On Class A preference and common shares – out of earnings fully covered by creditable tax;
2. On Class B preference and common shares – out of earnings having little or no creditable tax;
3. On Class C preference and common shares – out of foreign source earnings.

It would seem reasonable to expect that the Class A shares would tend to be held by Canadian corporate and individual shareholders, that the Class B shares would tend to be held by pension funds and other exempt shareholders and the Class C shares by foreign shareholders since a benefit flowing to any class of shares should tend to raise the price of all the shares so long as they are fully interchangeable.

Table A-2

COMPANY X

Computation of Canadian Corporate Tax and Integration of Corporate and Shareholder Tax After Reorganization

	Company X			Canadian Subsidiaries		Foreign Subsidiaries		Shareholders			
	Surplus Account	Creditable Canadian Tax	Creditable foreign Tax	Paying Full Tax	Paying* Less Than Full Tax	Treaty Countries	Non-Treaty Countries	Other Canadian Corporations	Canadian Individuals	Exempt Canadian Entities	Foreign Persons
Balance of retained earnings	$58,500	$10,000	$1,500	$20,000	$ 5,000	$15,000	$10,000				
Earnings of year before tax				$50,000	$20,000	$10,000	$12,000				
Corporate tax				(25,000)	(3,000)	(5,000)	(3,000)				
After tax earnings				$25,000	$17,000	$ 5,000	$ 9,000				
				$45,000	$22,000	$20,000	$19,000				
Dividends paid on											
Class A Preference Shares	7,450							$ 850	$6,600		
Creditable foreign tax			(1)1,315					150	1,165		
Creditable Cdn. tax		(2)2,410						275	2,135		
	$51,050	$ 7,590	$ 185								
Dividend from Cdn. subsidiaries paying less than full Cdn. tax	(3)1,450	725									
	$52,500	$ 8,315	$ 185		(1,450)						
Dividends paid on Class A common shares	17,000							10,000	7,000		
Creditable foreign tax			(4) 185					109	76		
Creditable Cdn. tax		(5) 8,315						4,891	3,424		
	$35,500	$ 0	$ 0								

Table A-2 (cont'd.)

COMPANY X

Computation of Canadian Corporate Tax and Integration of Corporate and Shareholder Tax After Reorganization

	Company X			Canadian Subsidiaries		Foreign Subsidiaries		Shareholders			
	Surplus Account	Creditable Canadian Tax	Creditable Foreign Tax	Paying Full Tax	Paying* Less Than Full Tax	Treaty Countries	Non-Treaty Countries	Other Canadians Corporations	Canadian Individuals	Exempt Canadian Entities	Foreign Persons
Dividends paid on Class B preference shares	(6)1,700									$1,700	
Dividends paid on Class B common shares	(6)3,000									3,000	
	$30,800										
Dividends from foreign subs. in treaty countries	(7)5,850		1,032			(6,882)					
	$36,650		$1,032								
Dividend paid on Class C preference shares	850										$ 850
Creditable foreign tax			(8) 150								150
Dividend paid on Class C common shares	5,000										5,000
Creditable foreign tax			(9) 882								882
Balance	$30,800	$ 0	$ 0	$45,000	$20,550	$13,118	$19,000				

NOTES TO TABLE A-2

(1)	15/85 of $7,450 to the extent of creditable foreign tax on hand	
(2)	50% of $7,450, less $1,315	
(3)	Receipt by X	$1,450
	Gross-up for creditable tax	725
		$2,175
	Tax at 33-1/3% fully creditable	$ 725
	Less credit	725
	Net tax to X	$ 0
(4)	15/85 of $17,000 to the extent of creditable foreign tax on hand	
(5)	50% of $17,000, less $185	
(6)	No creditable tax on hand	
(7)	Dividend payment	$6,882
	Less foreign withholding tax –15% fully creditable	1,032
	Net receipt by X (exempt)	$5,850
(8)	15/85 of $850	
(9)	15/85 of $5,000	

*Tax currently payable less than 50% of reported earnings.

Table A-3

COMPANY X

Comparison of Position Before and After Reorganization

	Before (Table A-1)		After (Table A-2)	
Retained earnings in Company X	$ 63,200		$ 30,800	
Creditable tax		$ 8,025		$ 0
Retained earnings in Canadian subsidiaries paying full tax	22,000		45,000	
Creditable tax		11,000		22,500
Retained earnings in Canadian subsidiaries paying less than full tax	9,000		20,550	
Creditable tax		0		775
Retained earnings in foreign subsidiaries in treaty countries	18,000		13,118	
Retained earnings in foreign subsidiaries in non-treaty countries	16,000		19,000	
	$128,200	$19,025	$128,468	$23,275
Increase			$ 268	$ 4,250

NOTES:

1. The increase in retained earnings arises from varying the source of foreign earnings in order to make funds available at the lowest current tax cost.
   Tax paid by X on withdrawal of profits from foreign subsidiaries was –

Before reorganization	$1,300
After	1,032
	$ 268

2. The increase in creditable tax arises from –

Avoiding loss of creditable tax on dividends to exempt Canadian entities			$2,350
Avoiding loss of creditable Canadian tax on dividends to foreign shareholders			2,678
			$5,028
Additional creditable tax arising on dividends from foreign subsidiaries –			
Tax after reorganization – all creditable		$1,032	
Tax before reorganization	$1,300		
Less non-creditable portion	275	1,025	7
			$5,035
Less increased creditable tax flowing to foreign common shareholders so as to eliminate the Canadian withholding tax of $668 –			
Creditable foreign tax flowing after reorganization		$ 882	
Creditable foreign tax flowing before reorganization		97	785
			$4,250

3. Retained earnings in foreign subsidiaries can only be made available to Company X by payment of a 15 per cent withholding tax – all of which would qualify as creditable foreign tax. In addition the remittance of retained earnings from foreign subsidiaries in non-treaty countries would require payment of Canadian tax at an effective cost to X of approximately 18 per cent of the amount of retained earnings remitted. 50 per cent of this Canadian tax would be creditable.

COMPANY X

COMMENTS ON TABLE A-2

To the extent possible it would seem that future dividend requirements of Company X would be satisfied in the following way:

Class A shares

1. by drawing profits from Canadian subsidiaries paying less than full Canadian tax but only to the extent that those profits were covered by creditable tax;
2. by drawing profits from Canadian subsidiaries paying full Canadian tax and whose dividends were thus fully covered by creditable tax.

Class B shares

1. by drawing profits from Canadian subsidiaries paying less than full tax – after having moved out all creditable tax with earlier dividends – provided rules are prescribed to permit a free flow of inter-corporate dividends;
2. by payment of ordinary dividends from existing start-up surplus of parent company without electing to pay the special 15 per cent tax;
3. by drawing profits from treaty country subsidiaries whose dividends were liable to the lowest possible withholding tax and would be exempt in Canada.

Class C shares

1. by drawing profits from foreign subsidiaries in treaty countries. This would require facing a withholding tax in order to have creditable foreign tax available to flow through to shareholders.

Ontario